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Voluntary Guideline for the Automatic Adjustment Clauses Standard Under the Public Utility Regulatory Policies Act of 1978

DEPARTMENT OF ENERGY

Economic Regulatory Administration

[Docket No. ERA-R-80-08]

Voluntary Guideline for the Automatic Adjustment Clauses Standard Under the Public Utility Regulatory Policies Act of 1978

AGENCY: Economic Regulatory Administration, Department of Energy.

ACTION: Notice of Voluntary Guideline.

SUMMARY: Title I of the Public Utility Regulatory Policies Act of 1978 (PURPA) establishes certain Federal purposes and policy standards for the regulation of electric utilities and imposes certain obligations upon State regulatory authorities and certain nonregulated utilities with respect to the standards established by sections 111 and 113. Under section 131 of PURPA, the Secretary of Energy is authorized to prescribe voluntary guidelines respecting consideration of the standards.

On April 24, 1980, the Department of Energy (DOE) issued a Notice of Proposed Voluntary Guideline for the Automatic Adjustment Clauses Standard Under the Public Utility Regulatory Policies Act of 1978 (45 FR 29234, May 1, 1980). This Notice discusses in the Preamble the public comments DOE received and presents the guideline in its final form as the Appendix hereto.

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SUPPLEMENTARY INFORMATION:

I. Background

On November 8, 1978, the President signed into law the Public Utility Regulatory Policies Act of 1978 (PURPA), Pub. L. 95-617, 92 Stat. 3117 *et seq.* (16 U.S.C. 2601 *et seq.*) as one part of the National Energy Act.

Section 113(b)(2) of PURPA establishes a standard for automatic adjustment clauses. The standard, which must be considered by State regulatory authorities and certain nonregulated utilities in a manner specified by PURPA, defines an automatic adjustment clause as:

> A provision of a rate schedule which provides for increases or decreases (or both), without prior hearing, in rates reflecting increases or decreases (or both) in costs incurred by an electric utility. Such term does not include an interim rate which takes effect subject to a later determination of the appropriate amount of the rate.

The standard, if implemented, provides that no electric utility may increase any rate pursuant to such clause unless the clause meets the requirements of PURPA section 115(e). Section 115(e) provides that an automatic adjustment clause must be determined at least every 4 years, by the State regulatory authority or nonregulated electric utility, after an evidentiary hearing, to provide incentives for efficient use of resources (including incentives for economical purchase and use of fuel and electric energy), and must be reviewed at least every 2 years, at an evidentiary hearing, to insure the maximum economies in those operations and purchases which affect the rates to which the clause applies.

The PURPA conferees, in adopting these provisions, did not endorse or encourage the use of automatic adjustment clauses nor did they suggest that the use of automatic adjustment clauses was inappropriate. In addition, the conferees did not indicate a preference for inclusion or exclusion of any particular item in an automatic adjustment clause.

The objective of an automatic adjustment clause is to mitigate the effect on utility revenues of relatively volatile cost items which a utility purchases on a continual basis. The most important of such cost items is fuel.

Generally, there are two basic circumstances which are important to consideration of automatic adjustment clause provisions. First, the expense for which automatic adjustment is allowed is a relatively uncontrollable and recurring expense. Second, the expense is variable with the volume of electricity sales; otherwise cost allocation is difficult and the adjustment cannot be made so as to recover for the utility precisely the increase (or decrease) which has occurred in operating costs.

The inclusion of fuel costs in adjustment clauses is intended to ensure the stability of utility earnings as fuel costs rise, while permitting rapid credits to consumers if fuel costs decline. Fuel costs are particularly significant because they account for a substantial percentage (over 50 percent for some utilities) of the total cost of supplying electricity and have increased dramatically in recent years. For this reason, this guideline focuses primarily on an automatic fuel adjustment clause.

While a fuel clause is intended to protect a utility's earnings stability, it does not ensure that a utility's fuel purchase policies and practices are the most economical and efficient possible. In fact, fuel adjustment clauses, in providing for automatic pass-through of certain costs, may permit, and even foster, inefficiency in fuel procurement practices and other utility management decisions. The automatic adjustment clauses standard established by PURPA is intended to address this situation by requiring regulatory authorities to consider and make determinations regarding the inclusion of efficiency incentives in automatic adjustment clauses. Section 131 of PURPA gives the Secretary of Energy the authority to prescribe voluntary guidelines respecting consideration of the standards. On April 24, 1980, DOE issued the proposed Voluntary Guideline for the Automatic Adjustment Clauses Standard (45 FR 29234, May 1, 1980) and solicited public comment for consideration in the development of the final guideline. A public hearing was held in Washington, D.C., on June 19, 1980. Testimony was received from 9 speakers. In all, oral and/or written comments were received from 66 respondents.

DOE evaluated the proposed guideline in light of each of the comments received. Part II of the Preamble describes the comments received and DOE's response. The guideline does not encourage or discourage the use of an automatic adjustment clause. In addition, except for certain purchased power transactions, the guideline does not suggest that any particular cost item be included in or excluded from an automatic adjustment clause. However, in the Preamble, discussion of comments received at times reflects upon the inclusion or exclusion of certain items in automatic adjustment clauses. Nonetheless, ultimate authority for determining what to include in an automatic adjustment clause and under what circumstances to employ such clauses resides with the State regulatory authority or the nonregulated utility.

II. Discussion of Comments and DOE's Response

The following is a discussion of comments received on the proposed guideline and DOE's response to these

comments. The discussion is organized according to the four issues identified in the proposed guideline and other major issues raised by commenters.

A. Provision of Incentives for Effective Fuel and Power Procurement Practices

Many comments pertaining to this guideline issue addressed the subjects of audits and potential refunds. Due to the number and variety of these comments, they are discussed separately in section E of this part of the Preamble. The remaining comments on this guideline issue dealt with automatic adjustment clause treatment of interchange power transactions and fuel and power transactions with affiliates.

With respect to interchange sales, commenters asserted that profits from such sales should be (a) flowed through in full to ratepayers, (b) retained in full by the utility, or (c) divided between the ratepayers and the utility. It was argued, on one hand, that ratepayers should benefit from such profits because, in the event of less sales than those envisioned in establishing the base rates, ratepayers would be required to pay the fixed charges not recovered in the interchange sales. On the other hand, commenters argued that the utility should retain these profits as an incentive to seek out opportunities for interchange sales. In addition, they asserted that equity holders of investor-owned utilities are entitled to a "reward" on facilities they financed.

Since ratepayers pay for the generation plant, they should benefit fully from any profits from interchange sales. Moreover, if costs of interchange purchases are passed through the automatic adjustment clause to the ratepayers, it would be inconsistent to treat profits from interchange sales in a different manner. Finally, as a regulated corporation, a utility should seek out opportunities for profitable interchange sales to reduce generation plant costs to its ratepayers. Nonetheless, the extent to which profits from interchange sales are to be flowed through to the ratepayers is a local issue and must be decided by State regulatory authorities and nonregulated utilities. No change has been made to the guideline in response to these comments.

With respect to interchange purchase of power, commenters asserted, variously, that (a) the costs of all interchange purchases should be included in automatic adjustment clauses calculations, (b) only the costs of emergency power purchases and economy purchases should be included in such calculations, or (c) only the fuel component of purchased power costs should be included.

All the costs of power purchases which are made to displace higher cost self-generation should be included in automatic adjustment clause calculations to the extent such costs are not included in the base rates. Permitting only a percentage of such costs to be passed through to ratepayers would create a disincentive for a utility to engage in cost saving purchases and ultimately result in higher rates.

The question of automatic adjustment clause treatment of those purchases which do not displace higher cost self-generation is more complex. Individual utility circumstances determine the particular reasons for such purchases. For example, when fuel supply shortages occur, utilities dependent on impacted fuels can stretch their supplies by aggressively engaging in interchange purchases of power generated from non-impacted fuels. In addition, utilities are encouraged under Section 202(a) of the Federal Power Act to enhance coordination of planning and operations with other utilities. Such coordination reduces the amount of needed installed reserve capacity and benefits ratepayers and utilities while increasing the likelihood of interchange purchases when equipment breakdowns occur. On the other hand, large non-cost saving interchange purchases may be attributable to serious utility management deficiencies resulting in a pervasive pattern of equipment outages.

The proposed guideline took the position that individual utility circumstances should be the determining factors in automatic adjustment clause treatment of non-cost saving power purchases. This position has not been changed in the final guideline.

The proposed guideline suggested careful assessment of automatic adjustment factors when either fuel or purchased power is obtainable from an affiliate or through an interlocking directorate in order to ensure arms length negotiations and reasonable prices or costs. Several commenters were concerned that the guideline not discourage entry by utilities into fuel production activities and that utilities not be arbitrarily denied full pass through of affiliate fuel charges. Other commenters agreed with the proposed guideline that fuel transactions between affiliates should receive careful evaluation.

The guideline does not discourage entry by utilities into fuel production activities. Investment in affiliate fuel production activities may provide needed fuel supply assurance. Such investment may also serve to moderate the cost of outside fuel purchases by providing cost experience useful in negotiating purchases and by providing, in effect, a ceiling on the delivered cost of fuels. However, the nature of affiliate transactions requires special regulatory evaluation. Accordingly, no changes have been made to the guideline.

One commenter suggested clarification of the phrase "lowest evaluated long-term fuel price" as used in the guideline in the context of measuring the quality of a utility's procurement practices. The phrase is intended to convey the concept that the lowest quoted price may not always be the lowest cost of fuel for a utility and its ratepayers when other factors are taken into consideration. For example, the evaluated price of coal may take into account the quoted price, Btu's/ton, quality of the coal (e.g., ash, sulphur, shale content), supplier delivery performance and price escalation provisions. A utility should, however, be able to substantiate its decision to choose other than the lowest quoted price. No change has been made to the guideline in response to this comment, since it is intended that regulatory authorities have considerable flexibility in determining, with respect to individual utility circumstances, the "lowest evaluated long term fuel price."

B. Provision of Incentives for Economic and Efficient Generation of Electricity

A number of commenters questioned whether an automatic adjustment clause is an appropriate context for examining the efficiency of utility plant operation. The comments ranged from whether it is possible to assess operating efficiency adequately, to whether such reviews are even necessary, to advocating that such reviews be undertaken exclusively in base rate proceedings.

The guideline recommends that utilities and regulatory authorities identify current performance parameters, establish cost-effective goals mindful of the utility-specific operating environment, establish procedures and programs to achieve identified goals and periodically monitor progress toward achieving these goals. There is no fundamental barrier to undertaking such an effort as part of an automatic adjustment clause process provided the performance parameters are evaluated over a reasonable time period.

The PURPA standard on automatic adjustment clauses includes the specific criterion that such clauses be determined "to provide incentives for efficient use of resources (including incentives for economical purchase and use of fuel and electric energy)" by the utility. In order to ensure that resources

are used efficiently, performance goals should be proposed by the utility, and evaluated and approved by the regulatory authority. Progress in achieving those goals should be monitored by the regulatory authority. The approach taken in the guideline assures ratepayers that, while bills rapidly respond to changing fuel prices, all reasonable measures are being undertaken by the utility and regulators to minimize fuel costs.

A number of commenters expressed concern that the utility performance efficiency goals recommended in the guideline would be interpreted by regulators as suggesting that rigid performance standards be made a part of an automatic adjustment clause process. In proposing that performance efficiency goals be set, DOE is not suggesting that precise and firm performance standards be established. Any such goals should be established by the utility and its regulatory authority in the context of the operating environment of the individual utility.

Performance efficiency goals should in particular, be evaluated for their implications for utility operating decisions. For example, adoption of a capacity factor standard may cause a utility to forego cost-saving electricity purchases and increase on-system generation in order to achieve a high capacity factor; or a utility may be induced to unnecessarily purchase high-cost, high-purity fuel in order to achieve a non-cost effective high plant availability factor. Thus, setting rigid performance efficiency standards may induce utilities to make improper operating decisions.

Appropriate changes have been made to the guideline to clarify that individual utility circumstances should determine the goals for relevant performance parameters and that the utility should achieve maximum economic efficiency over time (lowest $/Mwh) for the energy it supplies. The guideline suggests that plant data available from the Nuclear Regulatory Commission (NRC) and the National Electric Reliability Council (NERC) may be useful in establishing individual goals. The guideline does not recommend that such data automatically be adopted for this purpose. In addition, the final guideline does not reference the Economic Regulatory Administration as a source for data on fossil fuel burning plants since the primary source of such data is the NERC.

Finally, DOE disagrees with one commenter who asserted that membership in a power pool assures that the least costly mix of generation and purchased power will be used. Membership in a power pool does not ensure that fuel is purchased at the lowest evaluated cost nor does it ensure that generation units are maintained for maximum efficiency.

C. Incorporation of Automatic Adjustment Charges Into the Rate Structure

A number of commenters asserted that, for a variety of reasons, fuel adjustment charges should not be based on marginal costs or time-of-use rates. These commenters reasoned that (1) advocating rates based on marginal costs is irrelevant and inappropriate to the automatic adjustment clause guideline, (2) not enough is known about designing time-of-day rates with a fuel adjustment charge, or (3) marginal cost based fuel (adjustment) charges are not necessary, especially if the month-to-month fluctuation in fuel costs is small.

Rate structures should be considered along with any automatic adjustment clause which adjusts such rates. A utility's rates provide the best incentives for end-use efficiency (conservation) and for efficient use of its own resources when they reflect marginal costs. The guideline recommends that special attention be given to the way in which fuel adjustment surcharges affect a utility's rate structure. Such surcharges should not distort incentives for energy conservation that have been incorporated into a basic rate structure which is based on marginal costs. Where time-varying rates are in effect, it is important to maintain the appropriate onpeak/offpeak price differential. The challenge is to develop a procedure for a fuel adjustment surcharge that comes as close as practicable to capturing the proper differentials in both fuel prices and generation mix used in different time periods.

One way to handle this problem is to assign surcharge increases to rating periods in a manner which reflects the assumptions about fuel use that were made when base rates were established. If, in the basic rate structure, the use of fuels, by rating periods, was analyzed and energy costs were assigned on the basis of this analysis, the automatic adjustment surcharge can be assigned to rating periods in a similar manner. For example, if in the basic rate structure, 60 percent of total oil fuel costs are identified as being applicable to the onpeak period, then 60 percent of any surcharge attributed to oil would also be assigned to onpeak useage. A procedure of this type can only be employed as long as surcharges are a small proportion of total energy costs. The basic rate structure should be readjusted when fuel cost changes become large. This requires no change to the guideline.

Comments were almost evenly divided on the issue of zero-based fuel costs, where the entire fuel expense is covered in the adjustment surcharge. Some commenters contended that zero-based fuel rates promote customer understanding of fuel costs, while others agreed with the proposed guideline that this practice may be misleading to consumers. Other commenters took the position that whether or not fuel costs are zero-based is inconsequential.

DOE does not agree with the comment that zero-based fuel costs promote customer understanding of fuel costs. Rate structures should clearly distinguish between the level of the fuel cost component at the time rates were last approved by a regulatory commission or nonregulated utility and the current fuel adjustment surcharge. Distinguishing between these two components of fuel costs on a customer's bill reduces the possibility that misunderstandings will occur about regulatory treatment and review of fuel costs. No change has been made to the guideline in this area.

Several commenters suggested that the fuel adjustment amount be based on estimated fuel costs with a provision for subsequent reconciliation. With this approach, the fuel adjustment surcharge may move accurately reflect both current fuel costs and customer usage. However, a number of regulatory jurisdictions prohibit the use of estimated costs. The guideline does not take a position on this approach.

A number of comments were received on the impact of deferred fuel accounting and regulatory lag on incorporating fuel adjustment charges into the rate structure. Some commenters raised objections to the use of deferred fuel accounting by regulatory authorities, arguing that it violates ratemaking fundamentals and may be illegal as retroactive ratemaking.

The guideline does not express a position on the use of deferred fuel accounting. The State regulatory authorities and nonregulated electric utilities should determine the appropriateness of deferred fuel accounting considering individual utility circumstances.

A number of commenters observed that regulatory lag cannot be entirely avoided in the normal ratemaking process and may create an incentive to cost minimization.

Regulatory lag usually does exist and to some extent may provide an incentive for the utility of minimize costs. On the other hand, an automatic adjustment

procedure which permits current pass-through of costs, subject to regualtory review, also provides a cost minimization incentive. In addition, regulatory lag may cause distortions in the price signals provided by rates, and impair, on a continuous basis, a utility's ability to earn its allowed rate of return. Lags in the pass-through of fuel costs to customers should be minimized. The guideline has been modified to reflect this position.

Several commenters observed that an automatic adjustment clause should reflect energy requirements (line losses) of the ratepayers served by customer class.

Line losses attributable to a primary service customer would usually be less than for a secondary service customer. Therefore, to allocate more accurately the actual costs of serving each customer class, voltage level should be considered in the fuel adjustment surcharge. The guideline has been modified to reflect this.

D. Incentive for Displacement of Scarce Fossil Fuels in the Generation Mix

Several commenters suggested that, as an incentive for replacement of oil and gas-fired capacity, a penalty (such as less than 100 percent pass-through) be imposed on oil and gas fuel-cost recovery. One commenter recommended that a coal conversion surcharge be included in automatic adjustment calculations to stimulate coal conversion.

The objective of an automatic adjustment clause is to mitigate the effect on utility revenues of relatively volatile cost items which a utility purchases on a continual basis. A coal conversion surcharge provision or a selective penalty for certain fuels may undermine this purpose. In addition, partial recovery of actual expenditures provides ratepayers with price signals which do not reflect the actual cost of service and may impair, on a continuous basis, a utility's ability to earn its allowed rate of return. Therefore, neither a coal conversion surcharge nor a selective penalty for certain fuels is recommended in the guideline.

Some commenters stated that the guidelines should clearly indicate that automatic fuel adjustment clauses should not be used to aid utilities in dealing with cash flow problems created by their construction programs.

The guideline recommends that the automatic fuel adjustment charge should track fuel and certain power transaction costs. Inclusion of other utility expenditures in an automatic adjustment clause is a local issue to be decided by the State regulatory authority or the nonregulated utility.

Several commenters contended that the guidelines is not the proper vehicle for encouraging the replacement of scarce fossil fuels with more abundant domestic fuels.

Incentives for efficient use of resources should include incentives to improve the efficiency of utility operations. In many cases, with current prices, the use of oil and natural gas in baseload units is economically inefficient. The State regulatory authority and nonregulated utility should determine the impact an automatic adjustment clause has on encouraging the continued use of high-cost fuels in the generation mix and act accordingly toward minimizing overall costs of generation. Therefore, it is appropriate for the guideline to advocate that special attention be given in automatic adjustment clause proceedings to oil and gas cost changes to ensure that utilities are sensitive to minimizing total generation costs over time. Accordingly, no change has been made to the guideline as a result of these comments.

A commenter observed that spent fuel disposal costs are fuel related and should be included in the fuel adjustment clause.

Such costs are controllable and are more appropriately included in the base rates. However, the treatment of spent fuel disposal costs is a matter for the State regulatory authorities or nonregulted utility to decide and is not addressed in the final guidelines.

E. Accounting and Management Audits

The comments submitted to DOE raise two areas of concern: (1) the nature and scope of audits, and (2) the advisability of refunds.

(1) *Audits.* The proposed guidelines recommended that review of a utility's management activities and procurement practices include an account audit of fuel transactions and a management audit of procurement practices. Many commenters supported this recommendation but made a number of suggestions or modifications. Several commenters offered suggestions regarding the frequency of audits. Some commenters reasoned that frequent management audits are not necessary or justified, since, generally, the operations of an electric utility do not change drastically over a short period of time.

The guideline recommends that management audits, as they relate to the operation of an automatic adjustment clause, should be performed every 4 years unless individual utility circumstances warrant more frequent audits. The recommendations developed as part of a management audit should, if appropriate, be implemented after an evidentiary hearing. In addition, an interim review of the utility's current management practices, relative to the operation of an automatic adjustment clause, should be undertaken at an evidentiary hearing every 2 years, or more frequently at the discretion of the regulatory authority. Such interim management reviews should include a comparison of the utility's current practices with the recommendations implemented after the management audit. Account audits should be performed as frequently as the regulatory authority considers necessary. It is DOE's opinion that this recommended audit/review procedure, combined with an evidentiary hearing, is an effective means of carrying out the provisions of section 115(e) of PURPA.

Several commenters, while supporting the use of management and account audits, were concerned that audits may be used to judge retrospectively whether utility operations were carried out perfectly, and that the scope of the proposed audits may be unnecessarily broad. One commenter suggested (1) an initial management audit of a utility's purchasing practices; and, (2) subsequent reviews to ascertain that approved practices are being observed.

As indicated above, the guidelines differentiates between a prior year management audit and an interim management review. The former would serve to establish, after an evidentiary hearing, accpetable fuel and purchased power procurement and generation practices for the utility. The interim management review, conducted at an evidentiary hearing, would service to determine if the utility's current procurement activities are in compliance with these practices. The scope and depth of both the management audit and the interim management review should be determined by the regulatory authority in accordance with its needs and the particular situation of the utility. No change has been made to the guidelines regarding account audits, since periodic account audits are necessary to ensure the accuracy of a utility's records concerning fuel and power transactions.

A number of commenters opposed the guideline requirement for account and management audits of utilities or contended that such audits should be subject to a cost/benefit analysis. Other commenters contended that utilities should participate in the selection of auditors

Account and management audits, conducted by auditors independent of

utility control, concerning utility operations are one method to "insure the maximum economies in those operations and purchases which affect the rates to which such [automatic adjustment] clause applies" (Section 115(e) of PURPA). The automatic flow-through of a substantial portion of the costs a utility incurs necessitates the adoption of a review process to insure that consumers are protected from unjustified activities on the part of the utility.

One commenter observed that public participation in the audit process, as mentioned in the proposed guideline, is not advisable since a number of procurement activities are confidential in nature, i.e., bid offerings, contract terms, etc.

The regulatory authority should determine the scope of public participation in any audit or review process to protect the interests of both the utility and the ratepayers. Consequently, the guideline, both proposed and final, suggest "appropriate opportunities" for public participation.

A suggestion was made that joint audits be performed in the case of multi-jurisdictional utilities.

Since there are potential economic advantages to joint audits, this approach may be considered and adopted at the discretion of the regulatory authorities. However, the guideline expresses no position on this issue.

(2) *Refunds.* A number of commenters contended that refunds to ratepayers should not be required under any circumstances. In support of this position, commenters argued that the threat of refund would result in increased costs of capital and would undermine a utility's financial stability. On the other hand, several commenters agreed with the proposed guidelines position on potential refunds.

To establish clear and fair practices for procurement of fuel and power is an appropriate function of regulators. To the extent utility management fails to follow such practices, an increase in the risk to investors and thus an increase in the cost of capital is also appropriate. If a utility has the benefit of an automatic adjustment clause, it should be expected to engage in efficient fuel and power procurement activities. It is the responsibility of the regulatory authority to determine which costs, if any, are unjustified based on the account audit and interim management review of current procurement practices.

One commenter suggested that since the proposed guideline provides a penalty for poor performance, a reward should be provided for exceptionally good performance.

With an automatic adjustment clause, a utility is given an extraordinary opportunity to quickly recover increased costs associated with a major portion of its revenues. Concomitant with this opportunity is a responsibility to act in a prudent manner.

Several commenters suggested that prospective adjustments to a utility's authorized rate of return, as opposed to refunds, should be the procedure for dealing with imprudent or fraudulent (unjustified) automatic adjustment clause activities.

The fuel adjustment revenue may have a different impact on various classes of ratepayers. Adjusting the rate of return to deal with adjustments attributable to unjustified activities may raise cost allocation questions in terms of who paid the over-charge and who receives the benefits of a lower overall rate of return. In addition, it is more appropriate to relate the penalty (refund) to the relevant activity (unjustified past fuel and purchased power transactions).

Some commenters contended that an automatic adjustment clause which contains a refund provision is, in effect, an interim rate which is excluded from the PURPA section 115(e) provisions.

The use of a refund mechanism as a means for enforcing automatic adjustment clause requirements does not constitute an interim rate. Moreover, there is nothing in the legislative history of PURPA to indicate that Congress intended to equate the possible use of a refund in this manner with the operation of an interim rate.

One commenter asserted that a provision for refunds may be illegal under the laws of certain States. Another commenter recommended that any refund obligation should be limited with respect to time and amount.

Although the final guideline recommends that the utility have a potential refund obligation of unjustified fuel and power procurement expenses, it contains no recommendations regarding specific details of a refund provision. The regulatory authority operating within a State should establish a refund provision only to the extent permitted by and consistent with applicable law. In addition, the regulatory authority should determine how its particular refund provision should operate.

F. Design of an Automatic Adjustment Clause

A majority of commenters argued that regulatory review, as opposed to a fuel price index, is the appropriate method for providing incentives for effective fuel and purchased power procurement practices and for efficient generation of electricity. In the proposed guideline DOE had requested comments on the fuel price index as a means of incorporating incentives into a fuel adjustment clause. The final guideline does not recommend the fuel price index approach at this time.

Some commenters recommended that an automatic adjustment clause be designed to provide less than 100 percent recovery of fuel cost increases.

This approach may be inconsistent with the purpose of an automatic adjustment clause. In addition, partial recovery of actual expenditures provides ratepayers with price signals which do not reflect the actual cost of service and may impair, on a continuous basis, a utility's ability to earn its allowed rate of return. Therefore, partial recoveries of fuel costs should be minimized.

Several commenters suggested that increases (or decreases) in fuel costs should not be automatically passed through to ratepayers unless such cost changes exceed a certain percentage and are approved by the appropriate regulatory body.

This position is not adopted in the guideline because changes in fuel costs should be passed through to ratepayers as rapidly and accurately as possible in order to keep costs and revenues in balance as well as to provide ratepayers with correct price signals. In addition, during periods of volatile fuel cost fluctuations, such a procedure could result in frequent hearings which could excessively burdensome and costly to the utility and to the regulatory body.

Several commenters suggested that the guideline be expanded to provide explicit guidance on other types of costs, other than fuel related, which might be included in an automatic adjustment clause.

As mentioned above, there are two basic circumstances which are important to consideration of automatic adjustment clause provisions. First, the expense for which automatic adjustment is allowed is a relatively uncontrollable and recurring expense. Second, the expense is variable with the volume of electricity sales; otherwise cost allocation is difficult and the adjustment cannot be made so as to recover for the utility precisely the increse (or decrease) which has occurred in operating costs. Fuel costs clearly and directly meet both circumstances. While an automatic adjustment clause may be the appropriate vehicle for recovery of other than fuel costs, the guideline has not been expanded to identify such costs explicitly. Most non-fuel costs are more appropriately treated within the basic rate case framework.

G. Need for an Automatic Adjustment Clause

Several commenters cautioned that the guideline should not undermine the basic purpose of the automatic adjustment clause which is to stabilize the financial condition of utilities.

An automatic adjustment clause is intended to recover (or refund) legitimate costs which change significantly between rate cases. The clause should not become a financial prop or catch-all which circumvents thorough regulatory review. The guideline provides advice to regulators on incentives for effective fuel procurement practices and for the efficient and economic generation of electricity while not undermining the basic purpose of the automatic adjustment clause.

A number of commenters contended that a fuel adjustment clause is unnecessary for utilities not faced with volatile and uncontrollable changes in fuel costs. Other commenters indicated that, because fuel cost revenues dominate utility cash flow, any appreciable lag in the recovery of these costs would be extremely detrimental to the future of the utility industry.

Depending on the type of fuel used and other factors, the need for an automatic adjustment clause differs from one utility to another. The issue of the need for an automatic adjustment clause is not properly within the scope of this guideline; it is an issue which should be addressed by the regulatory authority familiar with the particular circumstances of the utility concerned.

III. PURPA Guideline for the Automatic Adjustment Clauses Standard

The appendix to this notice contains the final guideline. The guideline is adopted as proposed except for the modifications described above and minor clarifying and conforming modifications.

(Public Utility Regulatory Policies Act of 1978, Pub. L. 95-617, 92 Stat. 3117 *et seq.* (16 U.S.C. 2601 *et seq.*); Department of Energy Organization Act, Pub. L. 95-91 (42 U.S.C. 7101 *et seq.*))

Issued in Washington, D.C., on December 3, 1980.

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Administrator, Economic Regulatory Administration.

Appendix.—PURPA Voluntary Guideline Number 3: Automatic Adjustment Clauses

A. Introduction

On November 8, 1978, the President signed into law the Public Utility Regulatory Policies Act of 1978 (PURPA), Pub. L. 95-617, 92 Stat. 3117 *et seq.* (16 U.S.C. 2601 *et seq.*) as one part of the National Energy Act.

Section 113(b)(2) of PURPA establishes a standard for automatic adjustment clauses for State regulatory authorities and certain nonregulated electric utilities. The standard provides that no electric utility may increase any rate pursuant to an automatic adjustment clause unless such clause meets the requirements set forth in PURPA section 115(e). Automatic adjustment clauses are tariff provisions that permit electric utilities to incorporate changes in selected costs—the most important and largest of which is fuel costs—into their rates without going through a full rate hearing. The adjustments to rates that occur under these clauses are intended to protect an electric utility's financial condition from large unavoidable cost changes which, because of their frequency, are difficult and costly for regulatory authorities to deal with in a timely manner.

Under section 115(e) of PURPA, an automatic adjustment clause is defined as:

A provision of a rate schedule which provides for increases or decreases (or both), without prior hearing, in rates reflecting increases or decreases (or both) in costs incurred by an electric utility. Such term does not include an interim rate which takes effect subject to later determination of the appropriate amount of the rate.

Section 115(e) further requires that an automatic adjustment clause, which is consistent with the standard, must be determined, at least every 4 years, by the State regulatory authority or nonregulated electric utility, after an evidentiary hearing, to provide incentives for efficient use of resources (including incentives for economical purchase and use of fuel and electric energy), and must be reviewed at least every 2 years, at an evidentiary hearing, to insure the maximum economies in those operations and purchases which affect the rates to which the clause applies.

Although the standard is primarily procedural in its orientation, it does clearly indicate that incentives for the economical purchase and use of fuel and electric energy should be part of any automatic adjustment clause. Such incentives may be provided through regular public review and in-depth staff analysis of utility fuel procurement practices and use of generating resources.

In addition, incentives for the efficient use of resources may also emerge as a consequence of the rates charged for electricity. Electric utility rates based on marginal costs confront users with a price for electricity which more closely reflects the cost of the fuel used in its generation than rates based on average cost. If electric energy must compete with other sources of energy on its economic merits, through a system of marginal cost-based rates, utilities will have strong incentives to purchase and use fuels economically.

B. Coverage

This guideline covers the PURPA standard on automatic adjustment clauses and applies specifically to all automatic fuel adjustment clauses for covered electric utilities.

C. Definitions

As used in this guideline, except as otherwise specifically provided—

"Automatic adjustment clause" means a provision of a rate schedule which provides for increases or decreases (or both), without prior hearing, in rates reflecting increases or decreases (or both) in costs incurred by an electric utility. Such term does not include an interim rate which takes effect subject to a later determination of the appropriate amount of the rate.

"Electric consumer" means any person, State agency or Federal agency to which electric energy is sold other than for purposes of resale.

"Electric utility" means any person, State agency, or Federal agency which sells electric energy.

"Nonregulated electric utility" means any electric utility other than a State regulated electric utility.

"Rate" means (a) any price, rate, charge, or classification made, demanded, observed, or received with respect to sale of electric energy by an electric utility to an electric consumer, (b) any rule, regulation or practice respecting any such rate, charge, or classification, and (c) any contract pertaining to the sale of electric energy to an electric consumer.

"Rate schedule" means the designation of the rates which an electric utility charges for electric energy.

"State agency" means a State, political subdivision thereof, and any agency or instrumentality of either.

"State regulatory authority" means any State agency which has ratemaking authority with respect to the sale of electric energy by any electric utility (other than such State agency), and in the case of an electric utility with respect to which the Tennessee Valley Authority has ratemaking authority, such term means the Tennessee Valley Authority.

D. DOE Guidance

Incentives which are established by regulators must be carefully designed. They can promote the effecient use of resources, but they can also place a utility in a position where its continued ability to provide reliable service to its customers is jeopardized. Extreme financial disincentives can seriously imperil a utility's cash flow and thus its ability to provide needed manintenance on its existing plants and equipment, and finance construction projects needed to meet increasing demands for electricity or displace existing oil or gas fired generating capacity. Therefore, in designing incentives for incorporation into an automatic adjustment clause, it is important to consider whether the incentives would tend to impede a utility's ability to provide reliable service.

This guideline is organized around four major issues which State regulatory authorities and nonregulated utilities should address in their consideration of the automatic adjustment clauses standard to determine if a utility is achieving the highest levels of economy and efficiency in fuel procurement and system operations. There are as follows:

(1) Provision of Incentives for Effective Fuel and Purchased Power Procurement Practices;

(2) Provision of Incentives for Economic and Efficient Generation of Electricity;

(3) Incorporation of Fuel Adjustment Charges into the Rate Structure;

(4) Provision of Incentives for the Displacement of Oil and Natural Gas in the Generation Mix.

Each of these issues is discussed below.

1. *Incentives for Effective Procurement Practices.* Incentives for effective procurement practices are most appropriately provided by a periodic review of fuel and power purchases with potential refunds for costs deemed to have been unjustifiably incurred. With respect to economic purchase of fuel, standardized methods for measuring management effectiveness are not readily available. Whether a utility has used sound procurement practices in purchasing fuels is best determined on a case-by-case basis, with appropriate opportunities for public participation.

Procedural review of management activities and procurement practices can be especially effective when tied to a potential refund obligation of unjustified expenses. The utility should carry the burden of showing that its policies and practices are economical and efficient. The review process should include, but not be limited to, the following items:

(a) An account audit, as required by the State regulatory authority or nonregulated utility, of fuel (and purchased power) transactions to:

i. Determine if fuel and associated costs (handling, etc.) are properly identified and recorded in the appropriate Uniform System of Accounts (Accounts 151, 501, 518, 555 etc.). Included in this determination should be a review of the current treatment of nuclear fuel costs (handling, storage and disposal costs, depreciation, etc.), a review of invoices, and a review of discount dates;

ii. Determine if purchased power and associated costs included therein are properly identified. Assure that purchases displacing higher cost self-generation are distinguished from purchases made for other reasons; and

iii. Determine if the accounting treatment of interchange transactions is proper.

(b) A management audit of the utility's practices for economical purchase and use of fuel and electric energy, conducted by auditors independent of utility control, at least every 4 years unless individual utility circumstances warrant more frequent audits. This audit should assess performance, identify opportunities for improvement, and develop recommendations for improvements or further action. Using the audit recommendations and other relevant information, such as the utility's generation performance goals discussed in section 2 below, the State regulatory authority or nonregulated utility should determine, in an evidentiary hearing, those utility practices which provide incentives for efficient use of resources (including incentives for economical purchase and use of fuel and electric energy) and, if appropriate, require the utility to implement them. The audit should include such practices as delegation of responsibility for procurement (organization); capacity to address both near and long-term requirements (current planning); updating procurement plans and monitoring the effectiveness of them (plan execution); allowance and treatment of specific accounts within the fuel adjustment clause and fuel source bids; procedures to check fuel quality, sizing of fuel stock levels, contract price measured against reasonably available alternatives (e.g., regional market prices), relevant contract terms and conditions, and any variations from contract terms. Also included would be an evaluation of the utility's plans to improve procurement procedures and to measure quality of procurement operations (develop an effective planning and decision model for achieving lowest evaluated long-term fuel prices).

(c) An interim review of the utility's current management practices for economical purchase and use of fuel and electric energy should be performed by the State regulatory authority or nonregulated utility at least every 2 years unless individual utility circumstance warrant more frequent review. This review should be conducted at an evidentiary hearing and should consist of an examination of the utility's current practices for economical purchase and use of fuel and electric energy relative to those implemented as a result of the management audit and the evidentiary hearing. During this review, the regulatory authority should make a determination as to whether opportunities for profitable sales and cost-saving purchases (especially when scarce fuels can be displaced) or interchange capacity and energy are being aggressively pursued by the utility. As a result of this interim management review, the State regulatory authority or nonregulated utility should determine whether the utility's fuel and power procurement activities were justified.

Scrutiny of automatic adjustment factors by the regulatory authority should cover an additional item where either fuel or purchased power is obtainable from an affiliate or through an interlocking directorate. The existence of such a relationship may necessitate reviewing transactions to insure arms-length negotiations as well as reasonableness of prices or costs passed through to the utility's customers. The Federal Energy Regulatory Commission (FERC) has some authority and responsibility in this area; however, utility systems operation and planning (which affect utility rates) occur at a regional level. As such, it is the responsibility of the State regulatory authority to determine the reasonableness of costs ultimately to be paid by ratepayers within its jurisdiction.

2. *Incentives for Economic and Efficient Generation of Electricity.* The econcomical use of fuel should be assessed, where possible, by identifying relevant performance parameters and establishing cost-effective goals for baseload units mindful of the operating environment, such as membership in an economically dispatched powerpool or the opportunity for economy purchases, of the individual utility. Procedures, practices and programs to achieve identified goals should be proposed by the utility and evaluated and approved by the regulatory authority. Progress

toward achieving those goals should be periodically monitored by the regulatory authority.

Performance data considered in the goal setting process should cover a sufficent historical period to provide adequate perspective. Therefore, compilation of adequate and accurate performance and maintenance data by the utility is essential to the goal setting process.

While local operating conditions usually preclude adoption of national performance data to establish local goals, national data may be useful for comparison purposes. National data for nuclear plants are available from the Nuclear Regulatory Commission. Similar data for fossil fuel burning plants are available from the National Electric Reliability Council.

The absence of abuse in the utility's administration of the fuel adjustment clause and, where appropriate, utility efforts to implement cost-effective programs for reducing consumption of scarce fuels and achieving maximum economic efficency over time (lowest $/Mwh) should be made review criteria for continuation or approval of an automatic adjustment clause. This review of a utility's performance should address the following in the context of the utility's operating environment:

(a) Availability and equivalent availability factors of baseload units,

(b) capacity factors of baseload units,

(c) Forced outage rates of baseload units,

(d) Utility's forecast for improved availability and proposals to achieve cost effective higher levels of performance of baseload units,

(e) Identification of needed capital improvements,

(f) Plans for effective preventive and outage maintenance of baseload generation units,

(g) Capital and operating cost increases necessary to achieve improved productivity from baseload units,

(h) specific plans for decreased use of scarce fuels,

(i) analysis of fuel cost implications of meeting environmental standards, e.g., low sulfur coal versus high sulfur coal with scrubbers based on minimum present worth of life cycle revenue requirements,

(j) demonstrations that purchased power displaced higher cost self-generation as a condition of recovering the total cost of such purchases, and

(k) Demonstrations that power purchases, for reasons other than displacement of higher cost self-generation, were prudent and justified as a condition of recovering the excess of the total cost of such purchases over the fuel cost component.

Reliance on after-the-fact reviews places a burden on the regulatory authority to determine whether a utility is fully identifying and exploiting cost-effective opportunities for increasing the performance of baseload generation. In addition, regulatory authorities will also need to be able to differentiate between situations in which an unplanned outage is due to events beyond the utility's control and those in which it is not. Some regulatory authorities may have to increase their expertise in the area of powerplant performance and maintenance in order to determine the level of expenditures which is in the best interest of utility customers.

3. *Incorporation of Fuel Adjustment Charges Into the Rate Structure.* The economical use of electric power by end-users can be affected by the way base period fuel costs are incorporated into rate structues. Fuel adjustment charges should be incorporated into rate structures in such a manner as to least distort the incentives for conservation.

Automatic adjustment clauses have generally been designed to track changes in average fuel costs because, like rates in general, they must conform to a revenue requirement based on average total costs. However, rates provide the best incentives for end-use efficiency (conservation) and for efficient use of utility resources when they reflect marginal costs rather than average costs. Therefore, where the energy cost component in the base rates varies by time of use, special attention must be given to the way in which fuel adjustment surcharges affect the rate structure of an electric utility to ensure that fuel adjustments (even if based on average fuel costs) do not unnecessarily distort incentives for energy conservation that have been incorporated into that rate structure.

The maintenance of appropriate onpeak/offpeak price differentials, where time-varying rates are in effect, is a specific problem that arises in this regard. The problem is likely to be greatest where the onpeak rate reflects the costs of oil-fired generation and the offpeak rate does not. If oil prices increase more rapidly than the prices for coal or nuclear fuel, then the onpeak/offpeak rate differential should widen. The challenge is to develop a fuel adjustment procedure that comes as close as possible to capturing the proper differentials in both fuel prices and generation mix used in different time periods.

Customers taking service at high voltage generally require less fuel per kilowatt-hour consumed than those taking service at low voltages. Thus, voltage level should be considered in the fuel adjustment surcharge to more accurately allocate the actual costs of serving each customer class.

Automatic adjustment surcharges should reflect current fuel costs to provide incentives for conservation. In this regard, any lag in reflecting the true cost of fuel and purchased power in the billing should be minimized.

Automatic adjustment surcharges should be small; the basic rate structure should be readjusted when fuel cost changes become large. Rate structures with zero-based fuel costs, where the entire fuel expense is covered in the adjustment surcharge, are generally inappropriate and misleading to the consumer.

4. *Incentives for Displacement of Scarce Fossil Fuels in the Generation Mix.* By allowing a utility to pass through fuel price increases automatically, automatic adjustment clauses can reduce incentives for cost effective replacement of oil and gas-fired capacity with new coal or nuclear capacity. Utility decisions to invest in new generation sources which use alternative fuels and which displace uneconomic uses of oil and gas can reduce the total revenues (and present value of life-cycle revenue requirements) collected from utility customers over the operating life of a new plant using coal, nuclear, or renewable energy resources.

Automatic adjustment clauses directly limit the timing and level of recovery of fuel costs and can bias decisions involving the replacement of oil and gas in the generation mix with coal and nuclear. Since the large capital costs of new baseload powerplants frequently result in cash flow problems, even when all increased fuel expenses are completely recovered through an automatic adjustment clause, financial penalties permitting only partial recovery of increased fuel costs may impede a utility's ability to undertake construction programs which would replace scarce fossil fuels with coal, nuclear, or renewable resources in the generation mix. Conversely, automatic flowthrough of fuel costs may also dissuade financially constrainted utilities from investing in capital intensive generating capacity.

In the consideration of the standard, the impact of any clause on a utility's ability and incentive to implement a system generation plan which minimizes total generation costs over time should receive careful analysis, including periodic reviews of system expansion plans, to establish that the long-term system fuel mix is economically justified.

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